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SUBJECT: EDRC ANNUAL REVIEW OF GERMANY

REF: (A) UOSEC D 09341, (B) STATE 083662, (C) OECD

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1. SUMMARY. EDRC ANNUAL REVIEW OF GERMANY APRIL 25 PROVIDED ONLY LIMITED INSIGHT INTO GERMAN EXPECTATIONS AND POLICY INTENTIONS FOR REMAINDER 1974. GERMANS AND SECRETARIAT AGREED ON PRIMARY NEED TO CONTAIN INFLATION, AND ON DESIRABILITY OF POSTPONING MAJOR POLICY INITIATIVES UNTIL UNCERTAINTIES CLARIFIED. GERMANS STRONGLY RESISTED SECRETARIAT SUGGESTIONS THAT INCOMES POLICY OR THRESHOLD AGREEMENTS BE USED AS COUNTER-INFLATIONARY MEASURES, AND INSISTED ON THEIR DELETION FROM DOCUMENT. IN BALANCE OF PAYMENTS AREA, GERMANS SAW NO REASON TO ORIENT DEMAND MANAGEMENT POLICY TO ACHIEVEMENT OF EXTERNAL BALANCE ESPECIALLY WHEN THIS MIGHT HAVE ADVERSE EFFECTS ON

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DOMESTIC INFLATION. GERMANY LOOKS TO FLOATING EX-

CHANGE RATE AS MAIN CONSIDERATION FOR OTHER COUNTRY'S INTERESTS. END SUMMARY.

2. REVIEW OF 1973 PERFORMANCE. SEVERAL DELS QUESTIONED GERMANS ON RELATIVE IMPORTANCE OF FISCAL AND MONETARY MEASURES IN BRINGING ABOUT SLACKENING OF ECONOMY IN SECOND HALF 1973. US DEL ASKED IF CYCLICAL ADJUSTMENT TO 1973-1 SPURT COULD HAVE BEEN MAJOR EXPLANATION. GERMANS UNCLEAR IN REPLIES BUT EMPHASIZED IMPORTANCE OF POLICY MEASURES TAKEN IN MAY 1973. ON EXTERNAL PERFORMANCE, GERMANS CONSIDERED MAIN REASONS FOR EXTRAORDINARY EXPORT GROWTH TO BE RELATIVE STRENGTH OF FOREIGN VERSUS DOMESTIC DEMAND, LOWER INFLATION RATES IN GERMANY, AND PERVERSE EFFECTS OF REVALUATION (COMPOUNDED BY EXPECTATIONS OF FURTHER REVALUATION) WHICH CAUSED FOREIGN IMPORTERS TO SPEED UP PURCHASES BEFORE PRICES ROSE, AND DOMESTIC IMPORTERS TO DELAY THEIR ORDERS PENDING LOWER IMPORT PRICES. THERE WAS NO ADEQUATE EXPLANATION OF GERMAN IMPORTERS' HESITATION WITH REGARD TO RAW MATERIALS IMPORTS AT TIME OF RAPIDLY RISING WORLD PRICES.

3. GROWTH, EMPLOYMENT AND PRICES. SECRETARIAT CIRCULATED REVISED TABLE 14 (REF C) WITH NEW FORECASTS BASED ON STRONG EXTERNAL PERFORMANCE OF GERMAN ECONOMY IN FIRST QUARTER 1974. REVISED FORECAST SEES EXPORTS RISING BY 9 PERCENT IN 1974, WITH CURRENT ACCOUNT SURPLUS OF \$2.5 BILLION. REAL GNP GROWTH HAS BEEN INCREASED TO 2 PERCENT; GNP DEFLATOR REMAINS UNCHANGED AT 8 PERCENT; CONSUMER PRICE RISE HAS BEEN DECREASED TO 9 PERCENT. COMPLETE REVISED FORECASTS BEING AIR POUCHED TO KINNELLY (EUR/RPE).

4. GERMANS CONSIDERED NEW SECRETARIAT FORECAST TO BE CLOSELY IN LINE WITH THEIR OWN AND THEY, TOO, SAW SIGNS OF STRENGTHENING IN ECONOMY. TWO PERCENT GNP GROWTH RATE WAS "GOOD CONSERVATIVE ESTIMATE", ALTHOUGH THEY EXPECTED PRIVATE AND PUBLIC CONSUMPTION TO PERFORM BETTER, AND FIXED INVESTMENT (ESLIMITED OFFICIAL USE

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PECIALLY HOUSING CONSTRUCTION) SLIGHTLY WORSE, THAN SECRETARIAT FORESAW. GNP DEFLATOR WOULD BE ABOUT 7.5 PERCENT, WHILE CONSUMER PRICES EXPECTED RISE SLIGHTLY LESS THAN 9 PERCENT. GERMANS SURPRISED AND PLEASED BY LOWER THAN EXPECTED INCREASE IN CPI DURING FIRST QUARTER 1974, WHICH THEY ATTRIBUTED TO MODEST DECLINE IN AGRICULTURE PRICES. ON EMPLOYMENT, GERMANS SAW NUMBER OF UNEMPLOYED RISING BY

ABOUT 200,000 AT END 1974, BUT NEVERTHELESS THEY THOUGHT
DECLINE IN FOREIGN WORKERS WOULD BE ONLY 50,000
VERSUS SECRETARIAT FORECAST OF 200,000.

5. DEMAND MANAGEMENT POLICIES: GERMANS MADE VERY
CLEAR THEIR CONVICTION THAT FIGHT AGAINST INFLA-
TION WAS TOP PRIORITY PROBLEM. HOWEVER, THEY

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AGREED WITH SECRETARIAT RECOMMENDATION (PARA 59,
REFDOC) THAT GERMANY SHOULD PURSUE CAUTIOUS POLICY
STANCE AND NOT TAKE IMMEDIATE MEASURES TO EITHER RE-
STRAIN OR STIMULATE ECONOMY. FRG DOES NOT ACCEPT
VIEWS OF PRIVATE ECONOMIC RESEARCH INSTITUTES IN
GERMANY, WHICH HAVE BEEN URGING MEASURES TO ACHIEVE
PRICE STABILITY REGARDLESS OF IMPACT ON EMPLOYMENT.
SECRETARIAT CONSIDERED GERMAN PRIORITIES TO BE REASON-
ABLE, AND HOPED THAT SUCCESSFUL CONTROL OF INFLATION

MIGHT HAVE STABILIZING IMPACT ON OTHER COUNTRIES AS WELL.

6. SECRETARIAT (ANDERSEN) NOTED THAT IT WOULD BE PREFERABLE FOR DOMESTIC DEMAND TO EXPAND AT SAME RATE AS GROWTH OF CAPACITY, PARTICULARLY IF EXTERNAL BALANCE IS TO BE ACHIEVED. HOWEVER, HE DID NOT THINK EXPANSIONARY MEASURES SHOULD BE TAKEN NOW, AS IT WAS EASY TO UNDERESTIMATE BASIC STRENGTH OF GERMAN ECONOMY LIMITED OFFICIAL USE

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AND SITUATION WOULD BE CLEARER IN FEW MONTHS TIME. GERMANS AGREED THAT THIS WAS NOT TIME TO STIMULATE, AND NOTED THAT PLANNED INCREASE IN BUDGETARY DEFICIT FOR 1974 WOULD GIVE EXTRA DM 7 BILLION IMPETUS TO DOMESTIC DEMAND. SECRETARIAT (KLAU) ADDED THAT STRONG EXPORT DEMAND MIGHT IN ANY CASE CAUSE OVERALL DEMAND TO BE CLOSE TO RATE OF GROWTH OF CAPACITY.

7. PRICE AND WAGE CONTROLS: GERMANS REACTED VERY STRONGLY TO SECRETARIAT SUGGESTIONS IN PARA 55 REFDOK THAT GERMANY CONSIDER ADOPTING THRESHOLD AGREEMENTS AND INCOMES POLICIES TO ENCOURAGE REASONABLENESS ON PART OF TRADE UNIONS. THEY INSISTED THAT GERMAN TRADE UNIONS WERE THEMSELVES OPPOSED TO SUCH MEASURES, BUT AT SAME TIME REVEALED CONCERN THAT INCLUSION OF SECRETARIAT SUGGESTIONS IN EDRC REPORT MIGHT ENCOURAGE READERS TO THINK ALONG THOSE LINES. GERMANS MADE CLEAR THAT OPPOSITION TO SUGGESTIONS WAS LARGELY POLITICAL, AND INSISTED THAT PARA 55 AND FINAL SENTENCE PARA 56 BE DROPPED.

8. SECRETARIAT REPLIED THAT EVEN IF SOLUTIONS ARE UNACCEPTABLE, IT HAD TO BE RECOGNIZED THAT THERE WAS A PROBLEM WITH INFLATION. ALL EVIDENCE INDICATED THAT DEMAND MANAGEMENT WAS NOT SUFFICIENT TO CONTROL INFLATION ON ITS OWN WITHOUT UNACCEPTABLE CONSEQUENCES FOR EMPLOYMENT. THUS, ATTENTION NEEDED TO BE FOCUSED ON POSSIBLE ADDITIONAL MEASURES WHICH COULD BE TAKEN. IN FINAL ANALYSIS, OECD WOULD NOT PUBLISH WHAT WAS POLITICALLY UNACCEPTABLE TO A MEMBER STATE.

9. BALANCE OF PAYMENTS: US DEL ASKED WHETHER GERMANS EXPECTED MAIN STIMULUS TO ECONOMY TO COME FROM DOMESTIC OR EXTERNAL SIDE, AND WHAT SIGNIFICANCE THIS WOULD HAVE FOR DOMESTIC INFLATION AND BALANCE OF PAYMENTS. GERMANS REPLIED THAT THEY WOULD PREFER FOREIGN DEMAND NOT TO INCREASE, BUT THIS WAS BASICALLY BEYOND THEIR CONTROL SINCE REVALUATION AND SUBSEQUENT PRICE

CHANGES WERE NOT HAVING DESIRED EFFECTS. THEY DID NOT
THINK IT WAS UP TO GERMANY TO FOREGO ANTI-INFLATION
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POLICIES IN ORDER TO ACHIEVE EXTERNAL BALANCE.
MAIN CONSIDERATION FOR OTHER COUNTRIES' INTERESTS
WAS MAINTAINANCE OF FLOATING EXCHANGE RATE.
SEVERAL DELS WONDERED WHETHER UPWARD PRESSURE ON EX-
CHANGE RATE MIGHT NOT ENCOURAGE CAPITAL INFLOWS WHICH
WOULD INTERFERE WITH DOMESTIC MONETARY OBJECTIVES.
GERMANS REPLIED THAT THEY WERE NOT AT PRESENT CON-
SIDERING SPECIAL MEASURES TO RESTRICT INFLOWS OR
ENCOURAGE OUTFLOWS.

10. GERMANS UNABLE TO PROVIDE FORECASTS OF CURRENT
ACCOUNT SURPLUS FOR 1974, ALTHOUGH THEY FELT SECRE-
TARIAT PREDICTION OF \$2.5 BILLION WAS NOT TOO HIGH.
US DEL NOTED THAT GERMANY ALREADY HAD ACCUMULATED
THIS MUCH SURPLUS IN FIRST QUARTER, AND ASKED WHY
GERMANY CONSIDERED IT UNLIKELY THAT SURPLUS WOULD
GROW STILL FURTHER. GERMANS ATTRIBUTED FIRST
QUARTER PERFORMANCE TO DEPRECIATION OF DM IN MONTHS
FOLLOWING OIL SUPPLY CRISIS, AND CONSIDERED IT PROBABLE
THAT SUBSEQUENT APPRECIATION OF CURRENCY WOULD HAVE
OPPOSITE EFFECT ON EXTERNAL BALANCE LATER IN YEAR.
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